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July 29, 2005

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Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: In the Matter of Special Access Rates for Price Cap Local Exchange Carrier, WC Docket No. 05-25

Dear Ms. Dortch:

Enclosed for filing please find Reply Comments of Verizon Communications Inc. in the above-referenced docket. This filing consists of a brief and supporting declarations. Some of the materials in the filing contain confidential information.

The enclosed two copies of this filing have been redacted for public inspection. We are also filing one paper copy of the confidential portions of this filing with the Secretary's Office under separate cover. Additional copies of the redacted and confidential versions are being provided to the members of the Commission staff pursuant to the requirements of the Public Notice and the Order Adopting Protective Order in this proceeding. We are also submitting a paper copy of this filing, redacted for public inspection, to Best Copy and Printing, Inc. (the Commission's copy contractor).

Please date-stamp the extra copy of this letter and return it to the individual delivering this package.

All inquiries relating to access (subject to the terms of any applicable protective order) to any confidential information should be addressed to:

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Thank you for your assistance in this matter.

Sincerely,

Sherry A. Ingram /AEB

Sherry A. Ingram

Enclosures

cc:
Pamela Arluk (WCB)
Tamara Preiss (WCB)

ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Special Access Rates for Price Cap Local Exchange Carriers	)	WC Docket No. 05-25
	)	

REPLY COMMENTS OF VERIZON

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REPLY COMMENTS OF VERIZON

I. INTRODUCTION

The only substantial evidence in the record shows that, since the implementation of pricing flexibility, special access rates have declined, competition has flourished, and customers have benefited through the introduction of new and innovative service plans, within both the price cap and the price flex frameworks. Moreover, notwithstanding disputes between price cap LECs and other parties on other issues, there is widespread agreement that LECs should have greater flexibility to negotiate individualized service agreements throughout their territory. Accordingly, the Commission should reject calls to reinitialize special access rates and instead should authorize LECs to negotiate customized service arrangements without regard to regulatory restrictions, while retaining existing price cap rules as a backstop where necessary during the transition to negotiated agreements.

In its opening comments, Verizon demonstrated that, over the past four years, prices paid by its special access customers have decreased by 16.6 percent in real terms (considering the effects of inflation). Even more impressive, these decreases occurred in the face of growing demand – for Verizon, the result is that special access lines increased by approximately 15 percent per year from 2001 through 2004, but its special access revenues increased by less than 5 percent per year. These facts show the polar opposite of market power – far from raising prices

above competitive levels or restricting output, Verizon's special access rates have continued to fall even as output has expanded.

Given the healthy state of special access competition, this is not surprising. Verizon submitted hundreds of pages of evidence confirming the existence of vigorous special access competition wherever there is appreciable demand for these services. Other price cap LECs submitted similarly extensive evidence, including competitive network maps, market share analyses, calculations of the percent of demand within easy reach of competitive fiber, and statistics regarding losses of special access business to cable companies and fixed wireless providers.

In stark contrast, the proponents of more intrusive regulation of special access rates failed to produce substantive evidence of their own competitive networks or the extent of their success using special access. No competitor provided maps of its networks, lists of the buildings it serves or the central offices or carrier hotels where it has fiber-based collocation, analyses of the percentage of special access demand within striking distance of its fiber, or evidence of its success in serving business customers using special access purchased from incumbents or others. Tellingly, some of the most aggressive special access competitors – cable companies such as Comcast, Cox, and Cablevision and fixed wireless providers such as Towerstream and First Avenue Networks – filed no comments at all.

Likewise, no party submitted evidence that the actual rates it pays for special access service are unreasonable. In fact, one party seeking greater regulation (PAETEC) was forthcoming enough to confirm the reasonableness of price cap LECs' special access rates, stating that its strategy of using ILEC special access has "worked extremely well" and that the economics of ILEC term and volume discounts "are compelling in the short term." And another

(SAVVIS) candidly disclosed that it was competing successfully using special access obtained overwhelmingly from non-ILEC sources (even when those sources resell capacity obtained from ILECs in combination with their own facilities).

Where parties have access to information and choose not to disclose it, the Commission must infer that the evidence they withhold is unfavorable to their case. Verizon 24 n. 15 *citing Int'l Union, UAW v. NLRB*, 459 F.2d 1329, 1336 (D.C. Cir. 1972) ("[W]hen a party has relevant evidence within his control which he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him."). While their strategy is perhaps understandable – after all, any customer of any service would prefer to pay lower prices than it already pays – it is unavailing. As Verizon and other price cap LECs have demonstrated, customers enjoy a wide range of special access options, and carriers are competing successfully using ILEC special access as well as their own alternatives and facilities obtained from third parties. The proper course, therefore, is to further relax regulation of special access rates, not to compel arbitrary and substantial reductions where the market is functioning effectively.

To this end, there is broad consensus – even from parties pressing for intrusive regulation, such as PAETEC, Ad Hoc, XO, and Sprint – that price cap LECs should be able to respond to customers' demands for greater flexibility throughout their service areas, and the Commission should move forward with such relief as rapidly as possible. Commercially negotiated agreements are the best long-term solution for assuring efficient, competitive results. In particular, the Commission should permit price cap LECs to negotiate individually tailored service agreements without regard to regulatory restrictions, while retaining price cap regulation as a transitional backstop in those areas where Phase II relief has not yet been obtained. Moreover, the Commission should revise the Phase II criteria to take into account non-collocated

alternative networks, and should require opponents of Phase II relief to submit detailed network maps and other evidence regarding the scope of their operations.

There is no legal, factual, or policy basis for reinitializing special access rates, withdrawing pricing flexibility, or otherwise compelling reductions in market-based prices. While the advocates of such measures invoke the mantra of excessive ARMIS returns, the Commission long ago held that accounting rates of return for specific services "serve no ratemaking purpose." And their contention that rates in "price flex" areas are simply too high is equally without economic foundation. The Commission should stay on its deregulatory course and move toward replacing regulation with negotiated agreements.

II. SPECIAL ACCESS RATES HAVE DECLINED UNDER PRICING FLEXIBILITY.

A. Verizon and Other Price Cap LECs Have Demonstrated that Overall Special Access Rates as Well as Rates for Individual Services Have Decreased Over the Past Four Years.

1. Rate Trends

Since the implementation of pricing flexibility in 2001, Verizon's overall special access revenues per line have dropped by 16.6 percent per year in real terms, output has increased, and customers have benefited through the introduction of individualized serving arrangements. Verizon 6; Taylor Decl. ¶ 16 (attached to Verizon's comments as Attachment C), Table 1, Figure 3.[1] These rate decreases occurred in the face of substantial growth in the number of special access lines—even though lines grew by 15.3 percent per year from 2001 through 2004, revenues grew by only 4.8 percent per year. Taylor Decl. ¶ 14; *see also id.* ¶ 26, Table 3

[1] Examining real, rather than nominal, changes in price provides a more accurate assessment of pricing trends because real prices account for changes in purchasing power. For example, if the price of a good increases two percent in nominal terms, but inflation is three percent, the actual price of the good as perceived by the consumer has decreased by one percent. Put another way, the consumer can buy more of the good for the same amount of money, even though the good's nominal price has increased.

(between 2002 and 2004, DS1 and DS3 prices paid by customers fell by 5.7 and 7.6 percent respectively in real terms).[2] Other price cap LECs demonstrated that their rates experienced similar declines. *See e.g.*, SBC 6, 21 (explaining that "the prices customers are actually paying for SBC special access services in Phase II MSAs ... have declined, not risen as some have alleged, since pricing flexibility began" and that "[i]nternal SBC revenue numbers show declining average DSn prices across SBC's entire serving area"); BellSouth 20-21 (showing that its DS1 monthly revenue per circuit declined by 17 percent over the past three years, its DS3 monthly revenue per circuit dropped by one-third, and after considering all discounts for DS1 and DS3 services, the average price per DS1 equivalent decreased by 23 percent between December 2001 and December 2004).

This detailed evidence – which is the only evidence on the record regarding the rates customers actually pay for ILEC special access – demonstrates that special access rates have decreased, not increased dramatically, under pricing flexibility.

2. Discount Plans

Competition forces Verizon to offer special access discount plans (with price breaks of 40 percent or more off month-to-month rates) and individually negotiated contract tariffs (with total discounts of up to 70 percent off month-to-month rates). *See generally* Lew Decl.[3] (attached to Verizon's comments as Attachment D). On the wholesale side, 85 percent of

[2] Verizon also showed that, in Phase II areas, both DS1 and DS3 rates declined in real terms between 2001 and 2004, with DS3 and DS1 channel terminations decreasing in real terms by 5.8 and 2.4 percent per year, respectively, even when circuits purchased at month-to-month rates are included in the calculations. Verizon 8 n.5; *see also* Taylor Decl. Table 8.

[3] Similarly, SBC and BellSouth showed that competition compels them to offer substantial discounts. *See, e.g.*, SBC 22 ("SBC has entered into scores (and pursued hundreds) of price-flex contract tariffs with individual customers – each one reducing the average price for special access and decreasing the cost of telecommunications service"); BellSouth 17-19 (detailing discount plans and noting that 90 percent of purchasers of DS1 service and almost 75 percent of DS3 customers obtain discounts through term or volume and term agreements).

Verizon's wholesale demand is met through services purchased under one or more of these discount plans and contract tariffs. Lew Decl. ¶ 62. Yet even with these discounts, Verizon regularly loses substantial business to wholesale customers that self-supply or obtain alternative facilities from traditional special access competitors, cable companies, utilities, or fixed wireless competitors. Verizon 9-10; Lew Decl. ¶¶ 71-72.

In addition, Verizon's wholesale customers – which account for approximately 80 percent of total special access demand – are successfully using special access services obtained from Verizon to compete against Verizon in providing a wide range of services to end users. In fact, alternative providers have competed effectively using Verizon's special access services as inputs in providing high-capacity services to the full range of business customers, including florists, antique shops, dry cleaners, and other small businesses. Lew Decl. ¶ 46. And when retail customers do purchase special access directly from Verizon, they frequently do so under discount plans and contract tariffs; indeed, fourteen of Verizon's contract tariffs were designed initially for enterprise customers. *See* Lew Decl. ¶ 68 n.126; Bruno Decl. ¶¶ 35-38 (Attachment E to Verizon's Comments). This experience confirms the reasonableness of Verizon's special access rates.

Further confirmation of the reasonableness of LEC special access rates comes from some of the very parties who are seeking more intrusive regulation. For example, PAETEC – which says (at ii) that it uses ILEC special access for 95 percent of its connections to end users – acknowledges that its strategy of combining its own switches with leased transport and special access facilities "has worked extremely well," and notes that is "has never gone through a bankruptcy or financial reorganization, but has managed to grow successfully while honoring its commitments to all of its creditors and investors." *Id.* 3. And PAETEC further concedes (at 9)

that the "economics of these arrangements [LECs' special access discount plans] are compelling in the short term." In fact, PAETEC has been so successful using ILEC special access that it recently announced that it had filed a registration statement for an initial public offering.[4]

Likewise, SAVVIS states that it obtains the "majority" of its special access circuits from "a third-party other than the in-region ILEC, although most of the time the end-to-end circuit includes an ILEC-provided component, such as a channel termination from the ILEC serving wire center to the customer premises." Broadwing/SAVVIS 7. In other words, SAVVIS acknowledges that it is possible to compete without relying on the ILEC directly for special access circuits, and that alternative providers that resell ILEC special access are able to capture substantial volumes of business from the ILEC.[5] Notably, SAVVIS's use of third-party special access circuits has not constrained its success in the marketplace. For the first quarter of 2005, it reported gross profit of $53.1 million on revenue of $162.2 million, earnings before interest, taxes, depreciation, and amortization (EBITDA) of $15.7 million, and positive operating cash flow of $10 million. *See* Lew Reply Ex. 2(d).

B. Claims That Special Access Rates Are Excessive Cannot Withstand Scrutiny.

The proponents of intrusive special access rate regulation raise several broad claims, but none of their assertions shows market failure or provides any basis for compelling reductions in

[4] Press Release, PAETEC Communications Press Release, PAETEC Announces Filing of Registration Statement for Initial Public Offering (April 22, 2005) (available at www.paetec.com).

[5] SAVVIS claims that its principal providers, AT&T and MCI, are able to get greater discounts than other special access resellers, Broadwing/SAVVIS 7, this is incorrect. Other special access wholesale customers receive equivalent or even greater discounts from Verizon than either AT&T or MCI. In fact, because many Verizon discount plans set discounts based on term rather than volume, other carriers can and do receive the same discounts as AT&T and MCI. For example, a customer with 10 DS1s that commits to a five-year term under one of Verizon's term plans receives the same exact discount off the same exact base rates as a customer with 1000 DS1s receives.

special access rates or discontinuing pricing flexibility. Before addressing their individual faults, however, it is worth emphasizing that the issue in this proceeding is not what return LECs are earning on their special access services, or whether rates in a certain area or for a certain service are higher or lower than rates in other areas or for other services. Rather, it is whether the market is driving price changes, supply is increasing commensurate with demand, and service providers are being responsive to customers' demands.[6] The answer to that question, as discussed above with respect to pricing and in section III with respect to competition, is clearly yes. Accordingly, any move to tighten regulation of special access rates would be regressive, harmful to consumers, and irreconcilable with burgeoning competition.

1. ARMIS Category-Specific Returns Are Inaccurate.

The principle argument of the parties seeking greater regulation is that the special access returns are excessive. *See, e.g.*, XO 5-6, Ionary Consulting 1, Broadwing/SAVVIS 28, Ad Hoc Telecommunications Users Committee ("Ad Hoc") 28 and Attachment A (ETI Report). As the Commission has long recognized, however, accounting rates of return reported in ARMIS do "not serve a ratemaking purpose." *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637 ¶ 199 (1991). Moreover, the Commission has emphasized that "reducing our regulatory reliance on earnings calculations based on accounting data is essential to the transition to a competitive marketplace." *See Price Cap Performance Review for Local Exchange*

[6] *See* Verizon 18-19 (citing *Petition on Behalf of the State of Hawaii, Public Utility Commission, for Authority To Extend Its Rate Regulation of Commercial Mobile Radio Services in the State of Hawaii*, 10 FCC Rcd 7872 ¶¶ 7, 25, 26 (1995), where the Commission explained that "determinations [of] whether rates fall within [the zone of reasonableness required by Section 201(b)] are not dictated by references to carriers' costs and earnings, but may take account of non-cost considerations such as whether rates further the public interest by tending to increase the supply of the item being produced and sold," that "evidence concerning dynamic factors" such as "growth and investment" is a "more persuasive market indicator than evidence concerning static factors" such as "prices or rates of return," and that it is important to consider whether carriers have been "restricting the output of [that] service to increase its price."

Carriers, 12 FCC Rcd 16642 ¶ 150 (1997). This is so because category-specific "rates of return calculated from ARMIS data bear no relationship with economic profits":

> ARMIS costs and investment for special access services are derived from the Part 32 Uniform System of Accounts by a multi-stage process that allocates costs and investment between regulated and nonregulated services, between regulated interstate and regulated intrastate services and among regulated interstate services and access rate elements. Costs and investment in these processes are assigned to the various categories on bases other than cost-causation, and by the time costs and investment for individual interstate special access rate elements are produced, the results bear no relationship with economic costs. Taylor Reply Decl., ¶ 13. (Attachment A hereto).

In short, although ARMIS may present a realistic picture of *overall* revenues, expenses, and investment, it is rife with arbitrary cost allocations and mismatches that render it unsuitable for judging category-specific earnings. *See* Verizon 19-23; Taylor Decl. ¶¶ 93-95; SBC 24-33; BellSouth 7-13; Iowa Telecom/Valor 12-13. One prime example is the treatment of DSL, which now accounts for **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** of Verizon's overall special access revenues, *see* Verizon 6 n.3, and thus is a major contributor to the ever-increasing arbitrariness of the reported ARMIS category-specific returns. All DSL revenues, but no DSL lines, are included in the ARMIS special access category. And all revenues associated with DSL demand are assigned to the special access category, yet only a portion of the related expenses and investment are. Although Ad Hoc suggests that any adjustment for DSL revenue would reduce rates of return by only few points, in reality, the inclusion of DSL revenue results in "a serious overestimate" of the growth of interstate special access revenues (and revenues per voice-grade equivalent). Based on ARMIS data, Verizon's revenue per voice-grade equivalent declined by 10.0 percent annually in real terms between 2001 and 2004, compared to a 16.6 percent decline when DSL revenues are

excluded – an overstatement of approximately 165 percent. Taylor Reply Decl. ¶ 19 & Figure 1. In short, it is "impossib[le]" to assign "fixed common costs and network investment in any meaningful way," Taylor Decl. ¶ 95, so any reported return for a specific service category is "economically meaningless." Taylor Reply Decl. ¶ 11.[7]

The parties relying on ARMIS make two main arguments in an effort to persuade the Commission that the reported special access returns nonetheless compel more intrusive regulation. Neither has merit.

First, Ad Hoc (at 29-31) and Nextel (at 13), both relying on the ETI Report, contend that costs are misallocated *into* the special access category, and thus ARMIS understates special access returns.[8] As an initial matter, even if Ad Hoc and Nextel were correct, which they are not, that would only confirm that the ARMIS cost allocations are arbitrary and cannot be used to determine category-specific returns. In any event, however, they are wrong in asserting that costs are overallocated into the special access category because interstate special access net investment is about one-third of total interstate investment, but special access loops are only about 2.5 percent of all end user lines. This argument erroneously assumes that investment per loop for special access circuits and end user common lines is identical, but this is not the case. Taylor Reply Decl. ¶ 17. Indeed, there are "significant technical differences" between special access circuits and common line loops, which mean that investment per special access loop is

[7] While commenters note that they have updated their previous analyses with more recent ARMIS data, "[t]he important question regarding these data is not whether they are up-to-date or pertain to every study area, but rather why these parties and their economists persist in citing data that have no relevance for assessing the prices and appropriate regulatory regime for ILEC special access services." Taylor Reply Decl. ¶ 12.

[8] Ad Hoc suggests (at 2-3) that it presents a "credible, unbiased, and informed perspective" and "has no commercial self interest in the imposition of unnecessary regulatory constraints." Clearly, however, Ad Hoc's members – whoever they are – have a "commercial self interest" in utilizing any available avenue (including the regulatory process) to secure the lowest rates.

significantly greater than investment per common line loop. For example, special access circuits are "designed" circuits and include equipment to condition, channelize and multiplex the circuit, which are not part of an end user common line loop. *Id.*

Second, several parties assert, again based on the ETI Report, that any misallocations are "minor" and "at the margins," and that the ARMIS data provide a reliable measure over time of the relationship between the growth in revenues and the growth in expenses and investment for special access services. *See, e.g.*, Ad Hoc 29, Nextel 13-14, PAETEC 5. In reality, the effects are anything but minor and at the margins. Fixed and shared and common costs are a significant portion of the LECs' total costs, so arbitrary divisions of those costs can have a major impact on reported results. *See* BellSouth 10.

Nor is it correct to assume that, regardless of the misallocations, trends in the arbitrary results themselves become meaningful. As BellSouth points out (at 10), this argument "attempts to use invalid estimates based on ARMIS data to determine whether the invalid figures become larger or smaller during the time period in which this inappropriate accounting framework is applied."

Moreover, while the ARMIS rules themselves have not been altered, the world has changed over the past four years, so it is incorrect to assume that apparent trends have any economic validity. For example, the "historical relationship between switched and special access demand growth reversed during this period" with special access growing and switched access demand falling. In such situations, there is no reason to look at any "trends," because "costs allocated to regulated services, to interstate services or to interstate special access services can diverge more and more from economic costs over time." Taylor Rely Decl. ¶ 15. In short, the category-specific revenues, expenses, and returns for a series of years are no less arbitrary than

the category-specific revenues, expenses, and returns for a single year. Service-specific ARMIS returns do not serve a ratemaking purpose, and arguments based on those returns must be dismissed.

2. Rates in Phase II Areas Have Not Increased Overall.

Several parties contend that Phase II rates either have remained the same or have increased since the introduction of pricing flexibility, and that rates in price flex areas often are higher than in price cap areas. *See, e.g.*, CompTel 6-7 and Fischer Decl., ATX *et al.* 10, Ad Hoc 15-21. These claims are not accurate, but even if they were, there still would be no need for regressive regulation.

First, these parties are "incorrect as a matter of economics because prices *paid* by customers have not increased—in fact, by all measure they have *decreased*—as ILECs have introduced and promoted discount plans." Taylor Reply Decl. ¶ 20 (emphasis added). With term and volume plans as well as contract tariffs, customers receive discounts of up to 70 percent off month-to-month rates, and approximately 85 percent of Verizon's wholesale special access revenues are purchased under a discount plan. *Id.*; *see also* Lew Decl. ¶ 62. These discounts have spurred a *reduction* in Verizon's DS1 and DS3 rates paid by customers in Phase II areas in real terms between 2001 and 2004. Indeed, for channel terminations, those rates declined in real terms by 2.4 and 5.8 percent per year, respectively, and, for the entire circuit, the rates declined by 4.1 and 1.4 percent respectively, even when circuits purchased at month-to-month rates are included in the calculation. Taylor Decl. Table 8. The fact that revenues per line for DS1 and DS3 services are continuing to decline in both price cap and price flex areas, regardless of

changes in individual short-term rates or rate elements, confirms "that market forces are making special access customers better off." *Id.* ¶ 22.[9]

Second, comparisons between price cap and price flex rates improperly assume the price cap rate "is a competitive market price." Taylor Decl. ¶ 36. But, "there is no economic reason to assume that the price cap levels of prices represents a competitive market price for individual special access services." Taylor Reply Decl. ¶ 25. Regulated rates are never a perfect substitute for market rates, which is the very reason that the Commission adopted pricing flexibility—so that prices could move toward market rates and away from artificially set price cap rates. *See also* SBC 23 (noting that "regulators are not omniscient and cannot precisely fix the rates that a fully competitive market would produce" and "to the extent the pace of competitive entry is slower in price cap MSAs than in pricing flexibility MSAs, one reason may be that rates in the former are materially *below* what would prevail in a free market (and thus discourage competitive entry)."). In this regard, the Commission itself noted in the *Pricing Flexibility Order* that "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas." *Access Charge Reform*, 14 FCC Rcd 14221 ¶ 155 (1999).

[9] As explained in Verizon's comments (at 23), in an increasingly competitive market, one would expect month-to-month rates to increase, with greater discounts for longer-term service arrangements, because there is a greater risk that customers will leave for other suppliers before the service provider has recovered all of its up-front costs. As Dr. Taylor notes, "competitive forces do not appear to compel reductions in month-to-month rates or existing discount plans but rather result in new contract tariffs and total billed revenue contracts. The effect of these offerings on prices paid by customers is not captured by changes in existing month-to-month and discount plan prices." Taylor Reply Decl. ¶ 23. This result is consistent with the industry practice of competitors as well. AT&T, for example, offers customer-specific agreements with large discounts off monthly rates. *See e.g.*, Pricing Schedule for AT&T Data Services, Master Agreement, Pricing Schedule No. 25702, effective May 25, 2005 (available at http://serviceguide.att.com/ndcaict/view.cfm?cid=78979).

Finally, it is difficult to measure whether Phase II flexibility resulted in increased per-circuit prices for any particular circuits. Special access services may be composed of several components (end user channel terminations, mileage, and POP-side channel terminations), some of which are subject to price cap regulation and some of which are subject to price flex regulation. Taylor Decl. ¶¶ 25, 36. And different components may have been granted Phase II flexibility in different MSAs at different times. Accordingly, there is no basis for concluding that price cap rates have increased overall in Phase II areas – let alone that such an increase, if it occurred, would compel the Commission to withdraw pricing flexibility and regulate rates more closely.

3. Comparison to TELRIC rates

Some parties allege that differences between special access rates and state-set UNE rates for unbundled loops and dedicated transport show that special access rates are excessive. *See, e.g.*, Ionary Consulting 5-7, BT Americas 5, Nextel 16, ATX *et al.* 5. There is no basis, however, for comparing special access rates, which are market-driven and/or price cap-regulated, with UNE rates, which are established pursuant to an economic model that speculates about the costs of a hypothetical network that no competitor could ever afford to build and operate.

First, all such a comparison shows is that TELRIC has been used to set rates *below* levels that prevail in competitive markets. Taylor Reply Decl. ¶ 27. In the real world, where competition drives a firm to price its services to recover incremental cost, that cost is not the hypothetical cost that would be faced by a firm serving the entire market as a wholesale provider that regularly replaces its existing plant with the most efficient available technology (as TELRIC presumes). *Id.* ("no firm can price its services at each instant at the lowest cost attainable by a hypothetical perfectly efficient firm optimized to serve the entire market with a network

containing nothing but the newest and most efficient technology"). In the provision of competitive services, therefore, it is the cost actually incurred by a firm that serves only a portion of the market, faces the constant risk of losing customers to competitors (and thus stranding investment) and employs a mix of old and new plant.[10]

Indeed, Chairman Martin and Commissioner Abernathy have recognized the real-world problems with the TELRIC, and noted that the pricing methodology is serious flawed. *See e.g., Review of the Commission's Rules Regarding The Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers,* Statement of Commissioner Kevin J. Martin, WC Docket No. 03-173 (Sept. 15, 2003) ("the existing TELRIC formula may provide incumbent service providers with an insufficient return on investment capital for new infrastructure"); Remarks by Commissioner Kevin J. Martin, Remarks at the 20th Annual PLI/FCBA Telecom Conference, At the Crossroad (Dec. 12, 2002) ("In a nutshell, the existing TELRIC formula fails to accurately measure the true risk of capital investment under current economic conditions, and creates an unnecessary barrier for the deployment of broadband facilities."); *Review of the Commission's Rules Regarding The Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers,* Statement of Commissioner Kathleen Q. Abernathy, WC Docket No. 03-173 (Sept. 15, 2003) ("the

[10] Comparisons between market-driven special access rates and TELRIC-driven UNE rates are further flawed because, as the Commission has recognized, many states have exacerbated the tendency of TELRIC to produce artificially low rates by employing costs of capital and depreciation factors that fail to reflect the risks of a fully competitive marketplace. *Review of the Commission's Rules Regarding The Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers,* 18 FCC Rcd 18,945 ¶¶ 83, 93 (2003) ("TELRIC NPRM"); Taylor Reply Decl. ¶ 28. Likewise, the Commission has tentatively concluded that the TELRIC methodology should "more closely account for the real-world attributes of the routing and topography of an incumbent's network in the development of forward-looking costs." *TELRIC NPRM* ¶ 52.

excessively hypothetical nature of the Commission's existing [TELRIC] standard sends inappropriate investment signals and produces irrational pricing in some instances.").

Further, experience from other highly competitive segments of the telecommunications industry – most notably long distance – shows that services with high fixed costs typically have prices that substantially exceed marginal costs. *See* Taylor Reply Decl. ¶ 29 ("where technology is characterized by a high proportion of fixed costs, incremental costs alone do not determine competitive market prices"). Indeed, Drs. Taylor and Kahn analyzed the long distance market in 1988 – three years after the Commission found the market sufficiently competitive to remove price cap regulation—and determined that AT&T's residential interstate domestic direct-dial customers were charged rates that ranged from 82 to 185 percent above incremental cost (the difference turning on whether marketing expenses were treated as incremental costs). *Id.* (*citing* Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon in FCC RM No. 10593, at 10-11 (Dec. 2, 2002)).

What's more, because pricing special access at TELRIC rates would be tantamount to treating special access facilities as UNEs, concluding that special access rates are unreasonable because they are higher than TELRIC rates would be an unlawful evasion of the D.C. Circuit's holding that the Commission may not require an element to be unbundled in the absence of impairment. As the court explained in *USTA I*, "nothing in the Act appears a license to inflict on the economy the [costs of unbundling] under conditions where [the Commission] had no reason to think doing so would bring on a significant enhancement of competition." *USTA v. FCC*, 290 F.3d 415, 29 (D.C. Cir. 2002), *cert. denied*, 538 U.S. 940 (2003). Likewise, in *USTA II*, the court cautioned that "[w]here competitors have access to necessary inputs at rates that allow

competition not only to survive but to flourish, it is hard to see any need for the Commission to impose the costs of mandatory unbundling." *USTA v. FCC*, 359 F.3d 554, 576 (D.C. Cir. 2004), *cert. denied*, 125 S.Ct. 313 (2004).

Finally, the rates for UNEs and access services are regulated under different statutory provisions – Section 252(d)(1) in the case of UNEs and Section 201 in the case of special access – and Congress explicitly chose *not* to apply the UNE pricing regime to access services. *See* 47 U.S.C. § 251(g). It is axiomatic that "when one statutory section includes particular language that is omit[ed] in another section of the same Act, it is generally presumed that Congress act[ed] intentionally and purposely in the disparate inclusion or exclusion." *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 452 (2002) (internal citations omitted); *see also AT&T Corp. v. FCC*, 323 F.3d 1081, 1087 (D.C. Cir. 2003).

4. Comparison to Long-Haul Transport Rates

T-Mobile submits a Declaration of Simon Wilkie, which purports to assess the competitiveness of special access rates by comparing prices for long-haul transport to Verizon's special access prices in New York. Wilkie's analysis suffers from fatal economic and econometric flaws. Taylor Reply Decl. ¶¶ 30-47.

As a threshold matter, Dr. Wilkie incorrectly assumes that the economic and technological characteristics of long-haul transport are similar to those of shorter-haul special access transport. Taylor Reply Decl. ¶¶ 34-43. In reality, the cost-per-mile for long-haul transport are likely to be significantly lower than the cost-per-mile on shorter-haul routes. This is so for two reasons. First, the fixed costs of providing service are spread over a much greater number of miles in long-haul transport than in short-haul transport. Accordingly, the amount of fixed costs that must be recovered per mile will be much smaller in the long-haul context.

Second, the variable costs of long-haul transport are much lower than for short-haul transport, in large measure due to differences in the way the circuits are provided. For example, long-haul transport is likely to be routed along railroad rights-of-way or other above-ground routes, and often will traverse long stretches of relatively uncongested, lesser populated or substantially lower rural areas where construction costs are substantially lower. Short-haul transport, in contrast is provided principally in metropolitan areas, where streets must be dug up in order to place cables under ground. Clearly, the cost of deploying fiber along railroad rights of law across the plains of rural Kansas will be far lower than the cost of deploying fiber in downtown Manhattan.

In addition, shorter-haul transport generally has a lower usable capacity than long-haul transport and uses multiple SONET rings more often than longer-haul transport, both of which contribute to higher costs per mile. And shorter-haul transport may often ride on lower-capacity and thus less efficient circuits than longer-haul transport, since less demand can be aggregated on many short-haul routes. Taylor Reply Decl. ¶ 37.

In addition, the different demand conditions on short-haul vs. long-haul routes contribute to the disparity in the way costs are covered, even if costs were the same on both types of routes:

> Prices in effectively competitive telecommunications markets are not determined solely by cost; demand conditions matter as well, for industries having a high proportion of fixed costs, because prices must be marked up above incremental cost for services in order to recover the total cost of the firm. Since the volume of demand for [long-haul transport] is an order of magnitude greater than the transport demand for [short-haul transport], it would not be surprising to see different mark-ups of price over incremental cost on those routes. Supply conditions other than cost matter as well – for example, the current glut of long-haul capacity. Thus, even if the cost per mile of transport on long-haul dense routes were the same as on short-haul sparse routes, it would not follow that the prices per mile for those services would be the same,

assuming both services to be provided in effectively competitive markets. Taylor Reply Decl. ¶ 41 (footnote omitted).

For all these reasons, "the price per mile for shorter-haul routes, *holding constant the level of competition*, should be higher than the price per mile for longer-haul routes," and accordingly, "one cannot properly use [Dr. Wilkie's] model estimated from longer-haul routes to predict competitive market prices on shorter-haul routes." *Id.* ¶ 42 (emphasis in original).[11]

Finally, Dr. Wilkie's statistical analysis is gravely flawed. Setting aside the fact that he provides little information about his model (and thus makes it difficult to assess its accuracy), he forecasts a result for a point (a 10-mile circuit) that is far from the data set he used to construct his model (where the shortest circuit was 100 miles). *Id.* ¶ 44 & Figure 3. This makes it highly likely that the predicted results depart significantly from the "true" competitive price for the short-haul circuit. *Id.* His analysis also assumes what kind of curve will fit the data, rather than allowing the data "to choose precisely how price per mile varies with mileage." *Id.* ¶ 45. Yet "the only thing that tells us how price per mile varies with mileage for small mileage is Dr. Wilkie's *assumption* about the functional form." *Id.* ¶ 46 (emphasis in original); *see also id.* Fig. 4. Finally, Dr. Wilkie's model "omits a variable (technology) that affects transport prices and varies systematically with mileage." *Id.* ¶ 47. Accordingly, his results give no indication of the competitiveness of special access rates.

[11] The same pattern holds true in other industries with high fixed costs, such as air transportation, where prices on short-haul routes are substantially higher than "benchmark prices" calculated using prices on long-haul routes. These differences are due principally to greater demand on long-haul routes, which enables costs to be spread over more units and airlines to use larger, more efficient aircraft. Taylor Reply Decl. ¶¶ 38-42 & Fig. 2.

III. SPECIAL ACCESS COMPETITION IS VIGOROUS.

A. Verizon And Other LECs Provided Comprehensive and Verifiable Evidence Detailing Vigorous Special Access Competition From Fiber-Based Competitors, Cable Companies, Fixed Wireless Providers, And Resellers Of Capacity Obtained From Others.

Verizon has provided comprehensive, verifiable evidence from a wide range of sources showing intense special access competition. Each source independently confirms that competition, both intra- and inter-modal, is thriving. *See* Verizon Comments 24-34; Lew Decl. ¶¶ 8-57 & Appendices B, C; Lew Decl. Exs. 4-45; Bruno Decl., Bruno Decl. Exs. 1-35; Pilgrim Decl. Other commenters, such as SBC, BellSouth and mid-size ILECs Valor and Iowa Telecom, likewise submitted evidence of "stiff competition" in the provision of special access services. SBC 10-12; SBC Casto Decl. ¶¶ 5-36; BellSouth 13-37; Iowa/Valor 15-18.

Notably, this evidence significantly understates the true extent of competition because there is no compulsion for competitive special access providers to report the full scope of their operations, and many withhold the information from public disclosure, as even some of the proponents of more intrusive regulation have recognized. *See e.g.*, Time Warner Telecom 13 (citing 2004 Fact Report as evidence of XO's lit buildings and noting that the number of competitive lit commercial buildings may be "unavailable" because the information is "closely guarded").

To review briefly, Verizon's fiber-based collocation inspections revealed that there is competitive fiber collocated in nearly *two thirds* of offices in MSAs that account for 80 percent of the demand for high-capacity special access services. Lew Decl. ¶¶ 10-12, Lew Decl. Exs. 2-5. In particular, Verizon found that that approximately 80 different carriers (excluding MCI) have collocated in Verizon wire centers in the top 40 MSAs in Verizon's territory and many of these collocating carriers have fiber in several dozen Verizon wire centers. Lew Decl. ¶¶ 10-12,